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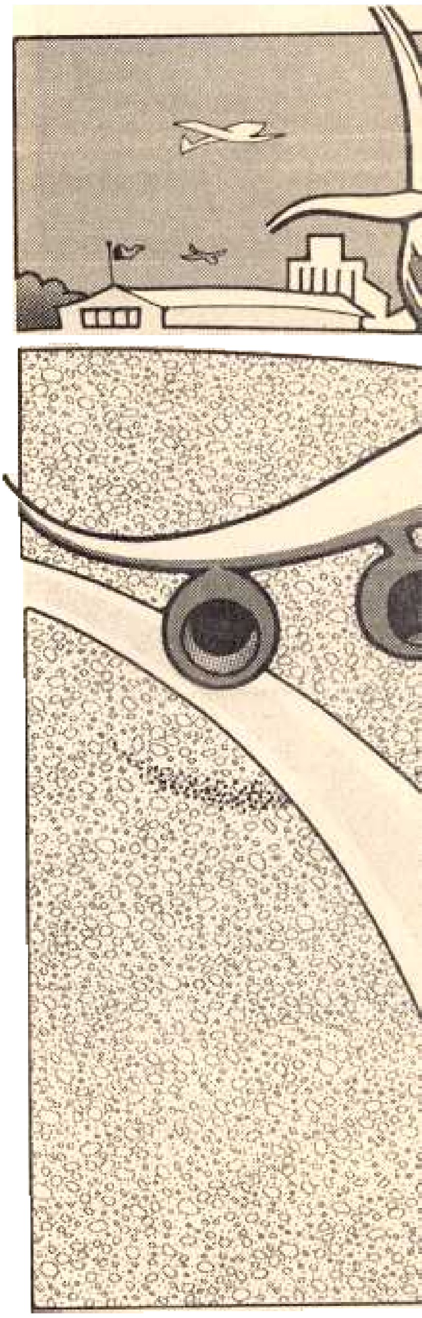
VIEWPOINTS

Frequent-Flyer Plans: Marketin

Employers, Price Competition and the IRS Come Up Losers

By P. KLEMPERER and I. P. L. PNG



Should a corporate executive in charge of purchasing be permitted to accept bribes for favoring a particular supplier? Should taxpayers be encouraged to evade income tax by accepting income in forms that are difficult for the Internal Revenue Service to monitor? Should competing firms be allowed to erect artificial barriers between themselves to inhibit competition?

Surprising as it may seem, airline frequent-flyer programs do all of these.

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The first frequent-flyer program was established by American Airlines. Today, almost all U.S. airlines have either established such a program or joined the existing program of another carrier.

These programs offer awards of free travel to passengers who have accumulated sufficient mileage on the member carriers.

Typically, these awards are of accelerating value—the award for 20,000 miles accumulated is more than twice as attractive as the award for 10,000 miles.

Consequently, the incentive is for a traveler to concentrate his travel in one or two such programs.

The frequent-flyer program is, without question, a stroke of marketing genius.

It is a commonplace of textbooks that a seller can realize a larger profit margin when his product is well established in a market segment that is insensitive to competition. Typically, firms achieve this through differentiation of their products to build brand loyalty among customers.

The problem in the airline industry was that there was little to differentiate the products of the major carriers and, consequently, little brand loyalty. At the stroke of a pen, however, the frequent-flyer program created intense customer loyalty, achieved through the accelerating structure of the awards.

The drastic implications of frequent-flyer programs for the ensuing division of the market were quickly appreciated by the major competitors of American Airlines.

For instance, United Airlines rushed to establish its own program, even though it did not then have the capability (unlike American) to computerize it.

It is important to emphasize that the customer loyalty built by frequent-flyer programs is artificial—it is not based on enhanced satisfaction of consumer wants, unlike the development of a milder soap or a more fuel-efficient sports car.

The primary target of frequent-flyer programs appears to be people who travel at the expense of someone else, whether it be their employers or clients.

This is indicated by the fact that the award is given to the traveler, not to the person or company that pays for the ticket.

When one person makes the purchase decision and another is responsible for paying, there arises what economists call an "agency problem."

Corporations appreciate this and seek to control the problem by concentrating the authority to make purchases in the hands of a small number of individuals, who can then be monitored closely.

Difficult for Travel

This is fine for stationery and furniture—but, as many corporations have discovered, more difficult for travel.

How is the corporate travel department to tell whether the 10 a.m. meeting in Chicago was scheduled at 10 a.m. to coincide with the arrival of a particular airline flight or because that was the most convenient time for the local representatives?

Major U.S. corporations have found, to their consternation, that their employees are strongly influenced by their membership in frequent-flyer programs.

There are many stories of executives routing their trips through Denver—at the expense of company time—to take advantage of special mileage bonuses for flights with changeovers in that hub.

In effect, the airlines have provided executives with a kickback to induce them to select particular suppliers—in this case of air travel—to their corporations.

Some corporations have tried to recover frequent-flyer awards from their employees, but the air-

g Device With Insidious Effects

JOHN SNYDER / Los Angeles Times

lines have refused to assist them with information.

Indeed, the airlines refuse to transfer frequent-flyer awards except to immediate relatives of the recipient of the awards.

Although the airlines do caution members of frequent-flyer programs that recipients of awards should consult their tax advisers, it is doubtful whether very many awards are reported as income.

Until now, airlines have not been required to report awards to the IRS as employers must report wages, salaries and fringe benefits such as subsidized housing. The frequent-flyer awards are, in effect, a tax-free form of income.

Indeed, many employees of corporations have come to regard them as an integral fringe benefit of employment.

To the extent that they do so, their employers can pay them less in taxable salary. This perhaps explains why corporations have not been so vigorous in their opposition to frequent-flyer programs—these are fast becoming one of the more valuable tax-sheltered fringe benefits of the 1980s.

Since, on average, the higher an executive's responsibility, the more likely he is to travel, this is a fringe benefit that benefits high-level executives more than workers on the factory floor.

The accelerating structure of the frequent-flyer awards creates a very strong customer loyalty to the airline—since the more one flies within one program, the more one wins, travelers are very reluctant to switch to alternative airlines.

The effect of this is to lock in the customer and make him less sensitive to price competition between airlines. Needless to mention, this lock-in is especially strong for

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people who travel at the expense of others.

Ordinarily, an airline that cuts its price can expect to draw substantial business away from competition. This incentive to cut price has been considerably dulled by frequent-flyer lock-in.

At present, it is difficult to gauge the effect of frequent-flyer programs on the extent of price competition between airlines. There are two confounding factors.

The first is that the introduction of these programs has coincided with the deregulation of the airline industry.

One of the major consequences of deregulation was the emergence of a number of no-frills, low-price carriers such as Jet America and People Express. These carriers offered fares much lower than those of the established airlines and triggered intense price wars that led to a general fall in fares of all airlines.

The second factor is that in the initial stages of programs to lock in customers, airlines will promote their programs and their product heavily so as to sign up more customers.

This is rational investment in market share — to yield high profits later, after customers are locked in.

In 1986, the year of the 10th birthday of the frequent-flyer program, the airline industry has crossed a watershed: On May 1, People Express, the classic no-frills carrier that caters to the traveler concerned about fares, announced its own frequent-flyer program.

Frequent-flyer programs are now spreading overseas and into related markets such as car rentals and hotels as the major U.S. programs sign up international carriers, car rental agencies and hotel chains.

Shouldn't something be done about this clever marketing device that is a kickback, offers a method of tax evasion and inhibits price competition between firms?